IN THE
SUPREME COURT OF THE UNITED STATES

October Term, 1977

No. 77-465

CHANDLER G. KETCHUM and HAROLD S. BIGLER,

Petitioners,

v.

EDWARD J. GREENE, HARRY B. HILTZ, JR., JOHN C. McCUTCHEN, DAVID G. ROOF, WILLIAM M. WAUGH, JR., RONALD B. LIVINGSTON, WILLIAM M. STEELE, and BABB, INC.,

Respondents.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

and

APPENDICES

Edmund K. Trent
Attorney for Petitioners
747 Union Trust Building
P.O. Box 2009
Pittsburgh, Pennsylvania 15230

Of counsel:
Reed Smith Shaw & McClay

TABLE OF CONTENTS

TABLE OF AUTHORITIES

Cases

Statute

Rule

Other Authorities

IN THE
SUPREME COURT OF THE UNITED STATES

October Term, 1977

No. ____________

CHANDLER G. KETCHUM and HAROLD S. BIGLER,

Petitioners,

v.

EDWARD J. GREENE, HARRY B. HILTZ, JR., JOHN C. McCUTCHEN, DAVID G. ROOF, WILLIAM M. WAUGH, JR., RONALD B. LIVINGSTON, WILLIAM M. STEELE, and BABB, INC.,

Respondents.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

Petitioners, Chandler G. Ketchum and Harold S. Bigler, respectfully pray that a writ of certiorari issue to review the judgment and opinion of the United States Court of Appeals for the Third Circuit entered in this proceeding on June 30, 1977.

OPINIONS BELOW

The following opinions in the case at bar are set forth in Appendix II hereto:

A. Opinion of the U.S. District Court for the Western District of Pennsylvania, Teitelbaum, J., dismissing the complaint, July 14, 1976, reported in 415 F. Supp. 1367.

B. Opinion of the U.S. Court of Appeals for the Third Circuit, Adams, J., affirming the dismissal of the complaint, June 30, 1976, No. 76-2268, reported in 557 F.2d 1022.

JURISDICTION

The judgment of the U.S. Court of Appeals for the Third Circuit was dated and entered on June 30, 1977, and this petition for writ of certiorari was filed within ninety (90) days of that date. This Court's jurisdiction is invoked under 28 U.S.C. § 1254(1).

QUESTION PRESENTED

When respondent directors failed to disclose to the shareholders their secret intention and clandestine scheme to remove petitioners from office and terminate their employment by the corporation, whereby they secured their reelection as directors, and forthwith discharged petitioners, was respondents' deception employed "in connnection with" the resale of petitioners' stock back to the corporation as required by a stock repurchase agreement automatically operative upon petitioners' discharge as corporate employees?

STATUTORY PROVISIONS INVOLVED

Section 10(b) of the Securities Exchange Act of 1934, c. 404 (48 Stat. 881, 891; 15 U.S.C. § 78j). Rule 10b-5 of the Securities and Exchange Commission (17 C.F.R. § 240.10b-5).

STATEMENT OF THE CASE

Petitioners, plaintiff-appellants below, former officers of the corporate defendant, Babb, Inc., an insurance brokerage house in Pittsburgh, filed an action charging the individual defendants, officers and directors of Babb, Inc., with violation of section 10(b) of the Securities Exchange Act of 1934, c. 404 (48 Stat. 881, 891; 15 U.S.C. § 78j) and of Rule 10b-5 (17 C.F.R. § 240.10b-5) promulgated by the Securities and Exchange Commission. After trial on plaintiffs' motion[1] to set aside the acts of the individual defendants which required plaintiffs to sell their shares of Babb, Inc. to the corporation pursuant to a stock retirement agreement, the District Court dismissed the complaint (46a), and petitioners appealed to the Third Circuit, which affirmed (67a). Petitioners then filed the instant petition for certiorari.

The facts upon which petitioners rely were all stipulated (1a) and are set forth in the opinion of the Court of Appeals (52a-54a). Until their ouster by

---

1. Plaintiffs moved for a preliminary injunction, but by agreement of the parties the case was heard as if on motion for a permanent injunction.

defendants on April 23, 1976, plaintiffs were the chairman of the board and the president of Babb, Inc. (8a, 52a), which had been incorporated in Pennsylvania in 1961 (4a). Plaintiffs had worked for it and its predecessors since 1945 and 1951, respectively (4a), were members of its board of directors, and owned between them 44.7% of its outstanding stock (2a, 31a, 52a). The seven individual defendants were officers of Babb, Inc. or of one of its subsidiaries and were members of Babb's board of directors, and five of them owned together 47.8% of its outstanding stock (8a, 12a, 31a). The remaining two members of the eleven-man board of directors owned no stock, and the remaining eight shareholders owned the balance of the stock, 7.4% (12a). All fifteen shareholders were employees of the corporation or of one of its wholly owned subsidiaries (6a).

By reason of long-established contractual arrangements embodied in a stock retirement agreement dated November 18, 1968, as amended, all shareholders of Babb, Inc. have been required to be employees of the corporation. If and when they cease to be employees, their stock must be surrendered to the corporation, which is required by the agreement to purchase it at a price calculated according to a

formula based upon the corporation's income.

Respondents' plot to remove petitioners from office and as employees of the corporation, thus forcing the sale of their stock to the corporation at a predetermined price, was begun late in 1975 (9a, 29a-30a, 53a). Shortly before the annual meeting of shareholders on April 23, 1976, a nominating committee, consisting of petitioner Bigler, respondent Waugh and Mr. Whitridge, a director but not a shareholder, agreed to recommend the reelection of the incumbent officers, and delivered a report to this effect to the board of directors (19a). Respondent Waugh joined in the nominating committee's report even though he did not in fact intend, and knew that the other respondents did not intend, to reelect petitioners. (18a, 19a, 20a).

The nominating committee's slate for re-election of the existing officers was presented to and agreed upon by all the directors at their meeting immediately preceding the annual shareholders' meeting on April 23, 1976 (19a, 53a). At that directors' meeting all the shareholders who subsequently attended the shareholders' meeting were present except one, Miss Zimmerman, the owner of five

shares, so that the committee's slate for officers was actually and affirmatively submitted to thirteen of the fourteen shareholders present at the meeting,[2] holding 462,563 out of 462,568 shares represented at the meeting.[3] Although respondents, constituting a majority of the board of directors, had all agreed not to vote for the nominating committee's slate of officers, they concealed their true intent and represented to the thirteen shareholders present at the directors' meeting that they would vote for the officers nominated by the nominating committee, including petitioner Ketchum for chairman and petitioner Bigler for president (19a).

---

2. Two were present by proxy to petitioner Ketchum and one by proxy to Whitridge (21a).

3. One shareholder, holding 777 shares, was not present either in person or by proxy (22a).

At the immediately ensuing annual shareholders meeting, of which notice accompanied by forms of proxy had been sent by United States mail (24a), respondents continued to conceal their intention (54a), and the shareholders,[4] believing that the board of directors had agreed upon the nominating committee's slate of officers and would elect them, unanimously voted to reelect the eleven incumbent directors (20a).

At the organization meeting of the board of directors immediately following the shareholders' meeting, the seven respondents, constituting a majority of the board, produced their own slate of officers (23a, 31a-32a, 54a), which had been secretly prepared and withheld[5] from the knowledge of the other four

4. Miss Zimmerman, the only shareholder who had not attended the directors' meeting, testified that she assumed that the exiting officers would be reelected by the directors for whose reelection she voted.

5. One of the respondent directors, Green, admitted that respondents had kept this plan secret in order to prevent petitioners from persuading other shareholders to vote differently.

directors, who were the two petitioners and Messrs. Whitridge and Hainsfurther. Respondents' slate was elected by a vote of seven to four, and petitioners were ousted from their offices of chairman of the board and president (23a). The board then summarily fired them, effective immediately, by a like vote of seven to four (23a-24a, 32a, 54a). By the same vote the board adopted a resolution to purchase petitioners' stock at $2.63 per share (24a, 54a), and, pursuant to documents previously prepared (25a), forthwith tendered the down payment of the purchase price as provided in the stock retirement agreement (25a, 33a). Petitioners claimed that their stock was worth $15 a share (53a).

The effect of respondents' misrepresentation of their intention as to how they would vote was that although they held a minority of the company's stock represented at the meeting, and a minority of all its lawfully issued and outstanding shares, they thwarted the will of the majority, as is evident from a tabulation of the number of shares voting at the shareholders' meeting (21a-22a):

Majority		Respondents	
petitioner Ketchum	120,000	respondent Waugh	87,000
petitioner Bigler	87,000	respondent Livingston	60,000
Higham, by proxy to Withridge	14,454	respondent Steele	60,000
Hainsfurther	6,500	respondent Green	12,500
Smith, by proxy to Ketchum	6,120	respondent McCutchen	2,000
Corigliano, by proxy to Ketchum	389	Parks	3,850
		Williams	2,750
Zimmerman	5		
	234,468		228,100

Thus, petitioners were fraudulently induced to vote for their own demise. They, and the others who were not parties to the conspiracy and who voted against the conspirators at the directors' meeting, were induced to vote for the seven respondents as directors by respondents' misrepresentation of their intention to reelect petitioners as officers of the corporation, when in fact their true intention was not to reelect petitioners but to throw them out, automatically resulting in the sale of petitioners' stock to the corporation.

REASONS FOR GRANTING THE WRIT

I. THE DECISION BELOW IS CONTRARY TO A RECENT PRIOR DECISION OF THE SUPREME COURT OF THE UNITED STATES.

The Securities Exchange Act of June 6, 1934, c. 404 (48 Stat. 881) provides in section 10 (15 U.S.C. § 78j):

> "It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails . . .
>
> "(b) To use or employ, in connection with the purchase or sale of any security . . . any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe. . . ." (Emphasis supplied).

Rule 10b-5 (17 CFR § 240.10b-5) defines broadly the practices which are forbidden:

> "It shall be unlawful . . .
>
> (a) To employ any device, scheme, or artifice to defraud,
>
> (b) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to

make the statements made, in the light of the circumstances under which they were made, not misleading, or

(c) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,

in connection with the purchase or sale of any security."

The Court of Appeals either found or assumed that all the elements necessary to prove a violation of the above section of the statute and the rule promulgated pursuant to it and in aid of its enforcement had been proved except that of showing that the deception had occurred "in connection with" the sale of petitioners' stock to the corporation. The latter subject is therefore the sole question raised by the present petition for certiorari.

The word "connection" covers, in both literal and figurative sense, the entire scale of relationship, from a firm binding or fastening together to loose association or even mere communication: The New Century Dictionary, New York, 1946. It denotes any degree of relationship on that scale, from the closest to the slightest.

Where the sale of a security is one event in a series of related transactions, and some deception occurs in one of the transactions, the deception is "in connection with" the sale.

<u>Supt. of Insurance v. Bankers Life & Cas. Co., 404 U.S. 6 (1971)</u>

The above decision is the leading authority for the rule that any deception in circumstances in which a sale of a security occurs violates section 10(b). Plaintiff there, the Superintendent of Insurance of New York, liquidator of Manhattan Casualty Co., sued Bakers Life & Casualty Co., Irving Trust Co., and others for damages of approximately $5,000,000 for violation of section 10(b). Bankers Life, the owner of all the stock of Manhattan, had agreed to sell it to one Begole for $5,000,000. Begole, although he had no money, obtained a $5,000,000 check from Irving Trust Co., bought the Manhattan stock with it, and having thus obtained control of Manhattan, caused it to sell the United States Treasury bonds in its investment portfolio for almost $5,000,000[6] and used the proceeds plus some additional cash to pay Irving Trust for the $5,000,000 check which it had issued to him.

---

6. $4,854,552.67

The District Court in dismissing the complaint held (300 F.Supp. 1083, S.D.N.Y. 1969) that it presented no more than a complicated scheme of common law fraud (p. 1104), saying with respect to the "in connection with" requirement (p. 1102):

> "Manifestly, the sale of Manhattan's portfolio and the purchase of the Manhattan shares were necessary steps toward the ultimate looting of Manhattan's assets. But Rule 10b-5 requires the employment of fraud in connection with a security transaction, which is essentially different from the effectuation of a security transaction in connection with a fraudulent activity.[16a]"

> "16a. . . . . As pleaded, the security transactions themselves, when considered from the viewpoint of section 10(b) and Rule 10b-5, were innocuous though constituting overt acts furthering the fraudulent scheme. Consequently, they cannot serve as the independent predicate for liability under section 10(b) and Rule 10b-5."

In affirming the dismissal of the action the Court of Appeals (430 F.2d 355, 2d Cir. 1970) held that the fraud on Manhattan was not in connection with the sale of its Treasury bonds, saying in the opinion of Judge Blumenfeld (p. 360):

> "The fraud which harmed the plaintiff consisted of the failure of Sweeny and his associates to account for the proceeds. There is a structural difference between the sale of the corporation's bonds at a concededly fair price and the subsequent fraudulent misappropriation of the proceeds received."

In dissenting, Judge Hays said (p. 362):

> "Since the vital center of the scheme, the vehicle for the perpetration of the fraud, was the sale of Manhattan's stock, it seems to me to be completely unrealistic to say that the fraud was not committed 'in connection with the purchase or sale of any security.' "

In reversing the Court of Appeals and remanding the case for trial, the Supreme Court held that the necessary connection had been shown between Begole's fraudulent scheme participated in by Sweeny and the sale of Manhattan's Treasury bonds, saying through Mr. Justice Douglas (pp. 9-12)

> "There certainly was an 'act' or 'practice' within the meaning of Rule 10b-5 which operated as 'a fraud or deceit' on Manhattan, the seller of the Government bonds. To be sure, the full market price was paid for those bonds; but the seller was duped into believing that it, the seller, would receive the proceeds. . . . .

> "Manhattan was injured as an investor through a deceptive device which deprived it of any compensation for the sale of its valuable block of securities.
>
> * * *
>
> "The Congress made clear that 'disregard of trust relationships by those whom the law should regard as fiduciaries, are all a single seamless web' along with manipulation, investor's ignorance, and the like. . . . Section 10(b) must be read flexibly, not technically and restrictively. Since there was a 'sale' of a security and since fraud was used 'in connection with' it, there is redress under § 10(b), whatever might be available as a remedy under state law."

With respect to the degree of closeness required between the deception and the sale, the Supreme Court set no outer limit at all, as the Court below recognized (59a, 557 F.2d at p. 1027). Mr. Justice Douglas said (pp. 12-13):

> "The crux of the present case is that Manhattan suffered an injury as a result of deceptive practices touching its sale of securities as an investor. As stated in Shell v. Hensley, 430 F.2d 819, 828:
>
> > 'When a person who is dealing with a corporation in a securities transaction denies the corporation's directors access to material information known to him, the corporation is disabled from availing itself of an informed judgment on the part of its board regarding the merits of the transaction. In this situation the private right of action recognized under Rule 10b-5 is available as a remedy for the corporate disability.'"

The facts at bar fall easily within the test quoted by Mr. Justice Douglas from Shell v. Hensley. Respondents, by depriving the stockholders of Babb, Inc. of knowledge of their intentions to cause the corporation to purchase petitioners' stock, disabled the corporation—the stockholders at the annual meeting—from making an informed judgment regarding the merits of the transaction, i.e., the merits of the corporation's purchase of approximately 45% of its outstanding stock. By voting for the reelection of the directors, the stockholders voted for the stock purchase without knowing that they were doing so.

That the Supreme Court did not place, or intend to place, any outer limit on the closeness of the connection of the deception to the sale is clear from the language used by Mr. Justice Douglas in the sentence immediately preceding the reference to Shell v. Hensley. He indicated that the deceptive practices need only "touch" the sale of securities (404 U.S. at pp. 12-13). The word "touch" in its abstract

sense means to affect in any way; "also, to affect injuriously, esp. in a slight degree." (The New Century Dictionary, supra). A person who is mentally deranged only slightly is described as being "touched in the head." Thus even the slightest connection between the fraud and the sale is sufficient to invoke section 10(b).

The Court below sought to place a limit on the connection relationship, but did so with respect to an immaterial point. Judge Adams (60 a, 557 F.2d at p. 1027) pointed to Justice Douglas' statement that "Congress by § 10(b) did not seek to regulate transactions which constitute no more than internal corporate mismanagement." Petitioners do not dispute this. The transaction at the heart of the present dispute does involve more than corporate mismanagement; it involves the sale of securities.

Judge Adams admits (60 a, 537 F.2d at p. 1027) that the complaint "stresses the importance of the relinquishment of plaintiffs' shares under the stock retirement plan," but says that this subject is mentioned only in the concluding paragraphs of the parties' stipulation of facts. What difference does it make where in the stipulation the sale was

mentioned? The events recited in the stipulation were placed in the order in which they occurred chronologically. The sale occurred last, and so it is described last. Are litigants to lose their rights because they claim them in a logical order? The reasoning of the Court below does not hold water.

Judge Adams attempts to bolster his analysis by stating (60 a) that "a substantial portion[7] of the relief sought is directed against the termination of plaintiffs as officers of the company." This does not nullify the respondents' deception in connection with the forced sale of plaintiffs' stock. All respondents' actions were part of one scheme: to get rid of petitioners and acquire their stock for the corporation at a low price, thereby enhancing the value of their own shares. If respondents had not intended the repurchase of petitioners' stock, they would not have discharged them as employees and would not have prepared, in advance of the shareholders' meeting, the papers necessary to tender the down payment of the purchase price.

---

7. In the report in 557 F.2d 1022, the words "a substantial portion" have been changed to "the dominant thrust." (p. 1027).

Judge Adams concludes this point (61 a, 557 F.2d at p. 1027) by saying that the elemental nature of the controversy is "a dispute arising from an internal contest for control of a corporation." This begs the question. The origin and nature of the dispute do not prevent the deception from being in connection with the sale of securities.

The Court below sets up (61 a, 557 F.2d at p. 1028) a second criterion to distinguish the Bankers Life case: that there the theft of the consideration was only one step removed from the bond transaction, whereas in the case at bar there were intermediate steps between defendants' misrepresentation to Babb's shareholders and plaintiffs' discharge as employees. How is this material? When the head of a long chain is pulled, the weight at its lower end moves even though many links intervene. When a bowling ball strikes the king pin on the first roll, it knocks down the other pins just as effectively as those it hits directly on two rolls.

Judge Adams seeks (64 a, 557 F.2d at p. 1029) to support his opinion for the Court below with the theory that the stock retirement agreement operated as an intervening cause between the challenged

conduct on the part of the respondents and the relinquishment of petitioners' shares, disrupting the connection. This reasoning is completely fallacious. Far from intervening in the series of transactions, the stock retirement agreement had been present from the beginning. Respondents framed their strategy around it, knowing that once they were reelected to Babb's board of directors the sale of petitioners' stock would be inevitably required as the result of their intended action to fire petitioners. It was they, not the agreement, which intervened to cause the sale. An inanimate object (the stock retirement agreement) cannot be an intervening cause. Some human action must set the cause in motion. When a defendant pushes plantiff's automobile against a telephone pole, crumpling it up, the pole is not an intervening cause excusing the defendant.

In the case at bar respondents' action set in motion the stock retirement agreement, resulting in the sale of petitioners' stock. Respondents' action was in connection with the sale.

II. THE DECISION BELOW IS CONTRARY TO PRIOR DECISIONS OF THE COURTS OF APPEALS OF OTHER CIRCUITS.

In Vine v. Beneficial Finance Company, 374 F.2d 627 (2d Cir. 1967), cited by petitioners in their briefs in the courts below but not mentioned in the opinion of either of those courts, defendants, who held class B stock, representing a small part of all the stock of Crown Finance Company, Inc., but who constituted a majority of its board of directors, in breach of their fiduciary duty to the majority class A shareholders induced them to accept a tender offer made by Beneficial Finance Company, which thereby acquired 95% of the class A shares. Beneficial then brought about a short-form merger between itself and Crown, in which defendants received for their class B stock of Crown an unfairly large share in Beneficial, and plaintiff Vine and the other non-consenting 5% of the A shareholders received too little. In reversing an order dismissing the complaint Circuit Judge Feinberg said in answer to one of defendant-appellee's arguments (p. 635):

> "But appellee says, assuming that conclusion of the merger makes appellant [Vine] a seller, any deception was in connection with the earlier stock acquisition from the ninety or ninety-five per cent of A stockholders, and that deception did not relate to appellant, who did not sell at that time. This ignores the simple fact that appellant would never be in the position of a forced seller were it not for the fraud. In essence, because of the distinctive nature of the short form merger procedure, appellee by deceiving A can cause B [appellant Vine] to become a seller. When this is all part of a single fraudulent scheme and that scheme is a classic example of deception of an entire class of Class A public stockholders, as alleged here, we think the policies of section 10(b) and Rule 10b-5 justify holding that fraud on A is 'in connection with' the force sale by B." (Emphasis supplied)

After the Supreme Court's decision in Bankers Life, the Second Circuit on rehearing en banc vacated a prior contrary decision and followed the rule advocated by petitioners at bar: Drachman v. Harvey, 453 F.2d 722 (2d Cir. 1972).

The language and decision of the Vine case are precisely applicable to the facts at bar. In both cases the deception was at least one step removed from the sale transaction. In the Vine case defendants deceived 95% of the class A shareholders, causing them to sell their stock to Beneficial, which was thereby placed in a position, through the short-form merger procedure, to cause the forced sale of the

remaining class A shares, owned by appellant Vine and the others constituting the remainder of the 5% who had not accepted Beneficial's tender offer. In the case at bar respondents, having an intent to fire petitioners, by deceiving petitioners and the other shareholders who together owned a majority of Babb's stock, placed themselves in a position to carry out their intent to fire petitioners, automatically activating the contract which caused the forced sale of their shares. Petitioners never would have been in the position of forced sellers if respondents had not secured their own reelection as a majority of the board by their misrepresentation to the other shareholders. Their deception was all part of a single fraudulent scheme to acquire petitioners' stock for the corporation at an extremely low price, thereby almost doubling the value of respondents' own shares.

The decision below is also contrary to the law in the Fifth Circuit as set forth in Smallwood v. Pearl Brewing Company, 489 F.2d 579 (5th Cir. 1974), where the shareholders of defendant Pearl Brewing Company had on September 9, 1969 approved an agreement of merger with Southdown, Inc., to become effective in December, 1969, under which each share of Pearl common stock would be

exchanged for one share of Southdown preferred and the Pearl shareholders would be able to sell up to 45% of their Southdown preferred at $45 per share to underwriters. On November 18, 1969 Southdown sent a letter to Pearl's shareholders telling them that to sell their shares of Southdown preferred on consummation of the merger they must deposit their Pearl stock certificates before 3:30 o'clock P.M. on December 2, 1968. Thereafter, Zapata Norness, Inc., a controlling shareholder of Southdown, agreed to purchase the deposited Pearl shares for $45 a share. On December 22, 1969 Pearl's board of directors voted to accept Zapata's offer and approved the consummation of the merger, and on December 30 Southdown and Pearl merged. Zapata then purchased the deposited shares for $45 each.

Plaintiff Smallwood, a Pearl shareholder who had attempted to deposit his 800 shares pursuant to the November 18 letter, but had missed the 3:30 o'clock deadline on December 2, then brought a class action charging that the November 18th letter failed to contain statements necessary to make it not misleading, in particular that it had neglected to state that the purchase offer could be made by a controlling shareholder of Zapata rather than by the underwriters.

Although the court affirmed a judgment for defendants, on the ground that even if Southdown's letter of November 18th to the Pearl common stockholders omitted material facts, defendants had not acted with any culpability, the opinion of Judge Wisdom held that that letter was sufficiently closely connected to the ultimate purchase of the Southdown preferred stock by Zapata to meet the test of the Bankers Life case, saying (p. 595):

> "Thus the Supreme Court in Bankers Life permitted a purchase by the plaintiff in one transaction to create standing to allege a violation of Rule 10b-5 in a different transaction when both transactions were alleged to be part of a single fraudulent scheme. With allegations of such a scheme, it is sufficient under the Bankers Life test that the transaction involving a purchase 'touch' the transaction alleged to involve the fraud. We do not hazard an opinion as to the outer limits of this test. It is important that the standard be fleshed out by a cautious case-by-case approach. It is clear to us, nonetheless, that the November 18 letter and the purchase by Zapata were tied to the merger transaction sufficiently tightly to pass the 'touch' test of Bankers Life. See also Drachman v. Harvey, 2 Cir. 1972, 453 F.2d 736 (en banc) (reversing panel decision, 453 F.2d 722, on authority of Bankers Life).

> ". . . . In essence, the sell-out provision provided an alternative to the statutory appraisal rights of the Pearl shareholder who harbored doubts about the value of the merger. Rather than decline to vote for the merger and accept the appraised value of the stock as of the day before the vote, under the sell-out provision a shareholder could vote for the merger and retain the option to recover $45 for at least 45 percent of his shares should the merger look economically unattractive later. The sell-out provision offered the possibility of a shareholder's at least partially bailing out. There can be little doubt that it worked to sweeten significantly the merger deal."

The decision below is also contrary to the rule adopted by the Court of Appeals for the Seventh Circuit in Jannes v. Microwave Communications, Inc., 461 F.2d 525 (7th Cir. 1972), a derivative action by shareholders on behalf of Microwave Communications, Inc., an Illinois corporation ("MCI"), which had been granted a license by the Federal Communications Commission in August 1969 to construct a microwave communications system. Microwave Communications of America, Inc., a Delaware corporation ("Mi-Com"), was formed in 1968. Defendant McGowan was its controlling shareholder and chairman. Defendant Goeken was president and a director of both MCI and Mi-Com. By misrepresentations to the other MCI directors, Goeken and defendant

Hermes, another MCI officer and director, caused the transfer of almost all of MCI's assets to Mi-Com in return for 25% of Mi-Com's common stock. At the same time MCI sold 69 shares of its common stock to McGowan at $700 a share. By other misrepresentations to other MCI shareholders the individual defendants acquired additional shares of MCI stock at a price below its value. The District Court dismissed the action, concluding that claims of corporate mismanagement or breach of fiduciary duty were not actionable under section 10b and rule 10b-5, because they did not involve fraud or deceit in connection with the sale or purchase of a security. The Court of Appeals reversed the dismissal on the ground that under the Bankers Life decision, handed down after the appeal had been taken, "the complaint alleged that MCI suffered an injury as a result of deceptive practices touching its purchase of securities when it received only 25 percent of the Mi-Com stock for its valuable assets." (p. 529).

CONCLUSION

The theme of the Bankers Life decision, followed by the Courts of Appeals for the Second, Fifth and Seventh Circuits, was that the deception was "in connection with" the sale of securities because both were parts of a larger, single, overall plan, which was carried out by a number of separate transactions. Every transaction was directly connected with the plan, and thus every transaction was connected with every other transaction, directly with some and indirectly with others. The unity of the plan resulted in the connection of each of its separate transactions with each other separate transaction.

The statutory requirement of connection does not differentiate between direct and indirect connection; it therefore permits any connection at all. Separate transactions which are part of an overall plan are logically connected with each other. They are certainly sufficiently connected to fall within the purpose of the statute.

In the case at bar all the acts of the individual defendants and the transactions in which they participated were part of a single plan: to get rid of

Ketchum and Bigler completely, not only as officers but as employees as well, and thereby acquire their stock for the corporation at a low price, enhancing the value of the individual defendants' stock. The Court below in separating the defendants' overall single-purpose plan into its component parts, saying that some were less important than others, disregarded the teaching of Bankers Life and adopted a rationale in conflict with the Supreme Court and with the Courts of Appeals of the other three circuits which have addressed themselves to the question. The petition for certiorari should be granted in order to terminate this conflict.

Respectfully submitted,

Edmund K. Trent
747 Union Trust Building
P. O. Box 2009
Pittsburgh, Pa. 15230
Attorney for petitioners

Of counsel:

Reed Smith Shaw & McClay
September 23, 1977

IN THE UNITED STATES DISTRICT COURT FOR THE WESTERN DISTRICT OF PENNSYLVANIA

CHANDLER G. KETCHUM and HAROLD S. BIGLER, Plaintiffs, v. EDWARD J. GREEN, HARRY B. HILTZ, JR., JOHN C. McCUTCHEN, DAVID G. ROOF, WILLIAM M. WAUGH, JR., RONALD B. LIVINGSTON, WILLIAM M. STEELE, and BABB, INC. Defendants.	Civil Action No. 76-571

STIPULATION OF FACTS NO. 1

NOW, May 24, 1976, the parties, by their undersigned counsel duly authorized to execute this instrument on their behalf, hereby stipulate and agree that the statements in the following numbered paragraphs are true and correct and may be offered in evidence by any of the parties as proof of the matter recited, subject to objection only on ground of

relevancy or materiality and subject to the right of any of the parties to offer evidence not inconsistent with any of said statements.

* * *

A. Plaintiffs

1. Plaintiff Chandler G. Ketchum is an individual who resides at 1519 Red Fern Drive, Upper St. Clair Township, Allegheny County, Pennsylvania.

2. Plaintiff Harold S. Bigler is an individual who resides at 1656 Beechwood Boulevard, in the City of Pittsburgh, Allegheny County, Pennsylvania.

B. Defendants

3. Defendant Ronald B. Livingston is an individual who resides at 470 Fairview Road, in the Borough of Fox Chapel, Allegheny County, Pennsylvania.

4. Defendant William M. Waugh, Jr. is an individual who resides at 16 Mt. Lebanon Boulevard, in the Township of Mt. Lebanon, Allegheny County, Pennsylvania.

5. Defendant William M. Steele is an individual who resides at 179 Gateshead Road, in Peters Township, Washington County, Pennsylvania.

6. Defendant Edward J. Green is an individual who resides at 80 Berry Street, in the City of Pittsburgh, Allegheny County, Pennsylvania.

7. Defendant John C. McCutchen is an individual who resides at 309 Maple Avenue, in the Borough of Edgewood, Allegheny County, Pennsylvania.

8. Defendant Harry B. Hiltz, Jr. is an individual who resides at 110 Tree Farm Road, in the Borough of Fox Chapel, Allegheny County, Pennsylvania.

9. Defendant David G. Roof is an individual who resides at 2465 Cambridge Drive, in the City of Hudson, Summit County, Ohio.

10. In 1945 or prior thereto, John Donald Babb (hereinafter designated "J. D. Babb") became engaged in the insurance business in Pittsburgh, Allegheny County, Pennsylvania.

11. In November, 1945, plaintiff Ketchum entered the employ of J. D. Babb.

12. In 1950 defendant Waugh entered the employ of J. D. Babb.

13. In 1951 plaintiff Bigler entered the employ of J.D. Babb.

14. In 1950 or 1951 J. D. Babb formed a partnership consisting of himself, plaintiff Ketchum and another to carry on said insurance business, and subsequently defendant Waugh and plaintiff Bigler became partners.

15. In 1960, defendant Steele joined said partnership.

C. Incorporation of the business

16. On December 22, 1961 defendant Babb, Inc. was incorporated under the laws of the Commonwealth of Pennsylvania under the name of Babb and Company, Incorporated, the business of said partnership was transferred to it in 1962, and the partners became shareholders.

17. The cost basis of the 207,000 shares of stock of Babb, Inc. issued to plaintiffs is ten cents per share.

18. A copy of the by-laws of Babb, Inc. which have been in effect since as early as January 1, 1975, has been marked stipulation exhibit C.

19. Said by-laws (Stip. Ex. C) contain no provision pertaining to a record date for shareholders entitled to notice of and to vote at shareholders' meetings.

20. Said by-laws (Stip. Ex. C) contain no express provision imposing on candidates for director any duty with respect to how they shall vote as directors, nor to announce how they shall vote.

21. In 1963 Livingston entered the employ of the corporation, and in 1965 he became a shareholder.

22. In January, 1967, J. D. Babb died. Plaintiffs and defendants Livingston, Waugh and Steele continued as officers and directors of Babb, Inc.

23. Subsequent to the incorporation of Babb, Inc., the shares of its stock were subject to a stock retirement agreement. Said agreement was on November 18, 1968 replaced by an agreement bearing said date which was amended by three amendments dated March 21, 1969, September 22, 1971, and October 29, 1974, respectively. Said agreement and said three amendments are attached as exhibit A to the complaint in the present action, and a copy thereof has been marked stipulation exhibit No. 1.

24. (This number not used.)

25. Since the incorporation of Babb, Inc. all its shareholders have been in its employ and held their stock under a stock repurchase agreement, and on the termination of their employment, regardless of by whom the termination was initiated, their stock was sold back to Babb, Inc. pursuant to such agreement, unless any terms of the agreement were modified by mutual consent.

26. In 1968 the name of the corporation was changed from Babb and Company, Incorporated to Babb, Inc.

27. In 1970 defendant McCutchen entered the employ of Babb, Inc., and in 1973 he became a shareholder.

28. In September, 1972, Planning Dynamics Incorporated, a Pennsylvania corporation with its headquarters in Pittsburgh (hereinafter designated "PDI"), was acquired by Babb, Inc., pursuant to an exchange of stock, and defendant Green, president of PDI, became a director, officer and shareholder of Babb, Inc.

29. Effective July 1, 1971, Higham, Neilson, Whitridge & Reid, a Pennsylvania corporation with its headquarters in Philadelphia (hereinafter designated "HNW&R"), was acquired by Babb, Inc.

30. In 1973 defendant Hiltz entered the employ of Babb, Inc.

31. In 1973 defendant Roof entered the employ of Babb, Inc.'s Cleveland-based subsidiary, Babb-Matthes, Inc.

32. On or prior to February 22, 1975, the board of directors of Babb, Inc. consisted of eleven members.

33. On February 22, 1975, the following individuals were elected or reelected members of the board of directors of Babb, Inc., and at the organization meeting of the board of directors held immediately thereafter they were elected or reelected to the offices set forth opposite their names:

Name		Office
plaintiff	Ketchum	chairman of the board
	Whitridge	vice chairman
plaintiff	Bigler	president
defendant	Livingston	vice president
defendant	Waugh	vice president
defendant	Steele	vice president and secretary
defendant	Green	
defendant	McCutchen	treasurer
defendant	Hiltz	vice president
	Hainsfurther	vice president
defendant	Roof	

34. (This number not used.)

35. The book value of Babb, Inc.'s stock on December 31, 1975 was $1.46 per share.

D. Events

36. In November or December of 1975, defendants Livingston, Waugh, Steele and Green discussed among themselves the possibility of removing plaintiffs as officers and employees of Babb, Inc.

37. In December, 1975 or January, 1976, defendants Livingston, Waugh, Steele and Green discussed with defendants McCutchen and Hiltz the possibility of removing plaintiffs as officers and employees of Babb, Inc.

38. In January or February, 1976, and from time to time thereafter, defendants Waugh, Steele and Livingston consulted the firm of Buchanan, Ingersoll, Rodewald, Kyle & Buerger in the City of Pittsburgh to obtain advice with respect to the possibility of removing plaintiffs as officers and employees of Babb, Inc.

39. Thereafter one or more or all of the defendants except Roof held a number of meetings and

discussions with respect to the removal of plaintiffs from Babb, Inc.

40. (This number not used.)

41. On or about March 30, 1976, defendants Livingston, Waugh and Steele met defendant Roof and discussed with him the removal of plaintiffs as officers and employees of Babb, Inc.

42. On April 6, 1976, defendant Roof decided to participate in removing plaintiffs.

43. By April 6, 1976, defendants had told no one else except possibly their wives or their secretaries of their plans to remove plaintiffs as officers and employees of Babb, Inc., and defendants wrote no letters and made no other writings or memoranda of their intended action.

44. By April 6, 1976 all the defendants had agreed that they would not vote for plaintiffs as officers of Babb, Inc. at the organization meeting of the board of directors to be held immediately following the annual meeting of shareholders on April 23, 1976.

45. Defendants made no disclosure to plaintiffs or the other shareholders of Babb, Inc. of their intention not to vote for the reelection of plaintiffs at the said organization meeting of the board of directors of Babb, Inc., except that about April 6, 1976 they told two other shareholders, Parks and Williams, of their said intention.

46. Between April 4 and 9, 1976, defendants and shareholders Parks and Williams executed a vote pooling agreement and irrevocable proxies in the form attached thereto and delivered them to one of the defendants. Neither said defendant nor any of the other defendants informed plaintiffs or the other shareholders of Babb, Inc. except Parks and Williams of said vote pooling agreement nor of said proxies. A copy of said vote pooling agreement with form of proxy attached has been marked stipulation exhibit 3.

47. Subsequent to the incorporation of Babb, Inc. additional shares of its stock were issued from time to time, so that on April 5, 1976, the holders of its stock were the following:

Name		No. of shares
plaintiff	Ketchum	120,000
plaintiff	Bigler	87,000
defendant	Waugh	87,000
defendant	Livingston	60,000
defendant	Steele	60,000
defendant	Green	12,500
defendant	McCutchen	2,000
Higham		14,454
Hainsfurther		6,500
Smith		6,120
Parks		3,850
Williams		2,750
Sneath		777
Corigliano		389
Zimmerman		5
Total		463,345

48. On April 5, 1976 defendant Steele as secretary of Babb, Inc. sent by United States mail to all the shareholders a notice of annual meeting of shareholders to be held April 23, 1976, with form of proxy. A copy of said notice and form of proxy (this copy being that sent to plaintiff Ketchum) has been marked stipulation exhibit 4.

49. Shareholders Smith and Corigliano gave their proxies to plaintiff Ketchum, and shareholder Higham gave his proxy to Mr. Whitridge.

50(a) The minutes of the annual shareholders' meeting of Babb, Inc. held February 23, 1974, contain the following (p. 3):

"4. Babb-Matthes, Inc.

Bigler reported that the Board recommended a block of 15,000 shares of stock be made available to Babb-Matthes, Inc. — fifty percent to be awarded on a performance basis and fifty percent to be purchased.

"It was moved by Bigler, seconded by Steele that a block of 15,000 shares of stock be made available to Babb-Matthes, Inc. — fifty percent to be awarded on a performance basis and fifty percent based on the valuation of stock as of 12/31/73 to be purchased in 1974 and 1975. The allocation is to be determined by management subject to the approval of the Board. Motion carried."

(b) The minutes of the annual shareholders' meeting of Babb, Inc. held February 22, 1975 contain nothing relating to stock options for employees of Babb-Matthes, Inc.

(c) The minutes of the board of directors' meeting of Babb, Inc. held July 17, 1975 contain the following (p. 2):

"B. Purchase Price under Babb-Matthes Stock Plan
Bigler reviewed the request for modification of the Babb-Matthes, Inc. Stock Bonus Plan (copy of July 17, 1975 memorandum attached).

"It was moved by Bigler, seconded by Hainsfurther, that the previously authorized bonus plan for Babb-Matthes key employees, be amended to provide 15,000 shares to be offered on the basis of 1/3 of the formula price times \$7.90. Allocation of shares to be determined by Roof and Bigler could be purchased by December 31, 1975 and December 31, 1976 providing a non-compete agreement is signed at time of purchase. Payment of such stock to be made within a two year period of the effective date of transfer subject to the terms

and conditions of the Restricted Stock Purchase Plan similar to that offer in 1972 to others. Motion carried."

A copy of the July 17, 1975 memorandum attached to said minutes has been marked stipulation exhibit 32.

(d) The minutes of the board of directors' meeting of Babb, Inc. held March 8, 1976 contain the following (p. 2):

"B. Babb Stock Options

1. Profit Center Head Stock Purchase Plan
Bigler presented his report in memorandum entitled, "Profit Center Head Stock Purchase Plan", a copy attached to minutes.

It was moved by Livingston, seconded by Whitridge, that the Profit Center Head Stock Option Plan as presented to the Board by Mr. Bigler for its approval be presented to the shareholders at the 1976 Annual Meeting as follows:

Hiltz - 10,000 shares guaranteed issuable January 1, 1977 and 5,000 additional shares based on 1976 performance.

Hainsfurther - 2,500 shares based upon 1976 performance

Stipanovich - 2,500 shares based upon 1976 performance

Roof - 2,500 shares based upon 1976 performance

Motion Carried. Steele and Waugh opposed.

"Waugh opposed because:

a. the scope of the responsibility of the Committee discussed to develop performance criteria did not have any flexibility in modification of maximum amount and that other key persons should be considered under this program.

"The Board further reaffirmed that Mr. Roof presently holds an option for 7,500 shares as approved by the shareholders at the 1975 Annual Meeting."

A copy of the Profit Center Head Stock Purchase Plan attached to said minutes has been marked stipulation exhibit 33.

51. On April 6, 1976, defendants caused a certificate, No. 173, for 7,500 shares of the stock of Babb, Inc. to be issued to defendant Roof, the same being signed by defendant Waugh as vice president and attested by defendant Steele as secretary.

52. On April 6, 1976, defendant Roof paid for said 7,500 shares with his personal note bearing six percent interest payable in five years.

53. Defendants did not tell plaintiffs or the other two directors, Whitridge and Hainsfurther, of the issuance of said certificate to defendant Roof.

54. On April 26, 1976, defendant McCutchen marked said certificate for 7,500 shares in the name of defendant Roof "void," and caused a new certificate, No. 174, for 7,500 shares to be issued in replacement of No. 173, the same being signed by defendant Waugh as chairman of the board and attested by defendant Steele as secretary.

55. On March 8, 1976, the board of directors appointed Mr. Whitridge, plaintiff Bigler and defendant Waugh a nominating committee to nominate (a) the directors to be elected at the annual meeting of shareholders to be held April 23, 1976, and (b) the officers to be elected at the organization meeting of the board of directors to be held immediately thereafter.

56. On March 8, 1976, the nominating committee met and agreed upon the persons whom they would nominate for directors to be voted on at the annual meeting of shareholders to be held April 23, 1976, and the persons whom they would nominate for officers at the organization meeting of the board of directors to be held immediately thereafter.

57. On March 8, 1976, the persons agreed upon by the nominating committee for directors were the eleven incumbents, and the persons agreed upon for officers were the incumbent officers, including plaintiff Ketchum as chairman and plaintiff Bigler as president. After March 8, the nominating committee held no further meetings, but the members communicated with each other by telephone or in person with respect to one or more additional nominees for

vice president. In addition to the incumbent officers they proposed one additional person for election as a vice president. At the board of directors' meeting held on April 23, 1976 immediately preceding the shareholders' meeting, Mr. Parks was added as an additional person to be elected a vice president.

58. On April 23, 1976, the nominating committee distributed to the directors its reports of nominations for directors and officers for the ensuing year, nominating the existing directors and the existing officers together with one additional vice president. Copies of said reports have been marked stipulation exhibits 5 and 6, respectively.*

59. In the past the recommendations of the nominating committee for directors have usually been followed by the shareholders, and its recommend-

---

* This stipulation shall not bar testimony that said reports were distributed before April 23, 1976.

ations for officers have usually been followed by the board of directors.*

60. On April 19, 1976 defendant Waugh, one of the members of the nominating committee, did not in fact intend, and he knew that the other defendants also did not intend, to vote as directors to reelect plaintiffs to the offices of chairman of the board and president, respectively.

61. Neither plaintiffs nor any of the shareholders other than defendants and Messrs. Parks and Williams had been informed by defendants of defendants' intention not to reelect plaintiffs to the offices they held nor of defendants' intention to terminate plaintiffs' employment and compel the sale of their stock to the corporation.

62. At the shareholders' meeting held April 23, 1976 the members of the board of directors who had been recommended by the nominating committee (listed on stipulation exhibit 5) were nominated and elected by unanimous voice vote.

* This stipulation shall not bar testimony that such recommendations have always been followed.

63. The shareholders voting at the meeting who had not been told by defendants of their agreement and intention not to vote for plaintiffs as officers of Babb, Inc. were the following:

Name	Number of shares
plaintiff Ketchum	120,000
plaintiff Bigler	87,000
Higham, by proxy to Whitridge	14,454
Hainsfurther	6,500
Smith, by proxy to Ketchum	6,120
Corigliano, by proxy to Ketchum	389
Zimmerman	5
	234,468

64. The following shareholders voting at the meeting knew of defendants' agreement and intention not to vote for plaintiffs as officers of Babb, Inc.:

Name	Number of shares
defendant Waugh	87,000
defendant Livingston	60,000
defendant Steele	60,000
defendant Green	12,500
defendant McCutchen	2,000
Parks	3,850
Williams	2,750
	228,100*

65. Shareholder Sneath, holding 777 shares, was not present at the meeting either in person or by proxy, and his shares were not voted.

66. Defendants Roof and Hiltz were present in person at the shareholders' meeting.

67. No one present at the shareholders' meeting except defendants, defendant Waugh's secretary, and shareholders Parks and Williams, had been told by defendants of the issuance to defendant Roof

* This stipulation paragraph is not intended to contradict stipulation paragraphs 51 and 66.

of the stock certificate described in stipulation paragraph 51.

68. At the organization meeting immediately following said shareholders' meeting, after the officers recommended by the nominating committee had been nominated, defendant Livingston nominated defendant Waugh for chairman and himself for president. He also nominated defendant Steele for vice chairman and secretary, defendant Hiltz for executive vice president and chief operating officer, and defendant McCutchen for vice president and chief financial officer and treasurer, defendant Roof for vice president, and others listed on his recommendation list dated April 23, 1976, a copy of which has been marked exhibit 17.

69. The candidates nominated by defendant Livingston named in paragraph 68 above were elected by the vote of the seven defendants against the vote of the two plaintiffs and the two other directors, Messrs. Hainsfurther and Whitridge.

70. The directors then adopted, by similar seven to four vote, a resolution terminating plaintiffs' employment effective at the close of business April

23, 1976, their salaries to continue for one week. At that time neither of plaintiffs had an employment contract with Babb, Inc.

71. The directors then adopted, by similar seven to four vote, a resolution to purchase plaintiffs' stock at $2.63 per share pursuant to the stock retirement agreement.

72. At said organization meeting no reason was given by any of the defendants or by any one else for terminating plaintiffs as officers and employees of Babb, Inc.

73. At the conclusion of the meeting defendant Waugh delivered letters to plaintiffs stating, inter alia, that they were discharged from their employment with Babb, Inc., their salaries to continue for one week. A copy of one of said letters has been marked stipulation exhibit 18.

74. On delivering said letters, defendant Waugh ordered plaintiffs not to conduct any business on behalf of Babb, Inc.

75. At the conclusion of the meeting defendant Waugh tendered to plaintiffs checks for the purchase price of their shares of stock in Babb, Inc. in the amounts of the down payments specified in the stock retirement agreement and drafts of notes for the balance, at the rate of $2.63 per share. Said checks had been prepared on April 22, and were signed on April 23, 1976. Plaintiffs returned said checks and drafts of notes to defendants.

76. On April 29, 1976, checks and executed notes were tendered to counsel for plaintiffs and were returned by him to counsel for defendants.

77. On April 25, 1976, defendant Hiltz presented Mr. Hainsfurther, a shareholder and director of Babb, Inc. with an opportunity to sign a copy of the vote pooling agreement which had been signed by the other defendants and Messrs. Parks and Williams between April 4 and 9, 1976, as described in stipulation paragraph 37, and Mr. Hainsfurther signed it on April 25, 1976. A copy of said vote pooling agreement

so signed by Mr. Hainsfurther has been marked stipulation exhibit 3(i).

Edmund K. Trent
Reed, Smith, Shaw & McClay
Attorneys for plaintiffs

John J. McLean, Jr.
Lewis U. Davis, Jr.
Attorneys for defendants

IN THE UNITED STATES DISTRICT COURT

FOR THE WESTERN DISTRICT OF PENNSYLVANIA

CHANDLER G. KETCHUM)
and HAROLD S. BIGLER,)
)
Plaintiffs,)
)
)
v.) CIVIL ACTION
) NO. 76-571
)
EDWARD J. GREEN,)
HARRY B. HILTZ,)
JOHN C. MC CUTCHEN,)
DAVID G. ROOF,)
WILLIAM M. WAUGH, JR.,)
RONALD B. LIVINGSTON,)
WILLIAM M. STEELE and)
BABB, INC.,)
)
Defendants.)

OPINION

This is an action for injunctive relief arising out of an internal struggle for control of Babb, Inc., a Pennsylvania corporation engaged primarily in the insurance brokerage business in Pittsburgh, Cleveland and Philadelphia.

Such a contest is rarely an amiable affair —

indeed, especially in the arena of the small, private corporation, a struggle for power is often intense and bitter, generated by a basic clash of strong personalities and conflicting business policy judgments. For the loser, the consequences can be both swift and severe, and it is therefore not surprising that the courts are frequently called upon to determine the legality of the mode of intra-corporate combat and the legitimacy of its outcome. But it is obviously not every corporate conflict that sparks a cognizable legal claim. Especially in the federal forum, where the prevailing principle of limited jurisdiction protects no less than the right and power of the state to adjudicate controversies governed by its laws, the Court must not permit empathy for the plight of the vanquished to impel an overreaching of subject matter jurisdiction in circumstances that do not clearly reveal a basis for a federal cause of action.

So it is with the difficult case sub judice, an action in equity founded for federal jurisdictional purposes upon an alleged violation of Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5, promulgated thereunder. Plaintiffs Ketchum and Bigler are, respectively, the recently-ousted chair-

man of the board and the recently-ousted president of Babb, Inc. (Babb). Their combined service with Babb and its organizational predecessors totals some 55 years, and, since 1967, they (along with certain of the defendants herein) have actively managed the corporation. During the period of their stewardship, Babb has grown from 30 to 140 employees, and its annual revenues have increased from $600,000 to more than $4,000,000.

Nonetheless, in late 1975, several of the individual defendants in this case, all seven of whom were and are directors of the corporation, began discussing among themselves the possibility of either severing their associations with Babb or, alternatively, removing plaintiffs from top management positions at the time of the 1976 elections. Babb had not shown a profit for at least three preceding years, and, in view of the defendant-directors, this decline was the direct result of what they deemed to be plaintiffs' "wasteful and counter-productive" diversion of corporate resources into "unrelated, losing ventures," and "repeated disregard" of the board of directors in the formulation of important corporate decisions. In early 1976, certain of the defendants, subsequently joined by the others, determined that

they would oppose plaintiffs' reelection as officers of the company.

On April 23, 1976, the date of the annual shareholders meeting and the critical juncture in the chain of events here in question, the eleven individuals who had comprised the membership of Babb's board of directors throughout the prior year — the two plaintiffs, seven defendants and two other persons not parties to this lawsuit — again were nominated by a committee of the board to serve as directors for the following year. By unanimous voice vote, the assembled shareholders reelected the same eleven individuals as directors.[1]

---

[1] It should be noted at this point that, since its incorporation in 1961, Babb has been held exclusively by company employees. As of April 23, 1976, the company's 470,845 shares of outstanding common stock were held by sixteen shareholder-employees, as follows:

Plaintiff Ketchum	(120,000 shares)
Plaintiff Bigler	(87,000 shares)
Defendant Waugh	(87,000 shares)
Defendant Livingston	(60,000 shares)
Defendant Steele	(60,000 shares)
Defendant Green	(12,500 shares)
Defendant McCutchen	(2,000 shares)
Defendant Roof	(7,500 shares)

Immediately following the shareholders meeting, the newly-reelected board met in accordance with corporate by-laws to elect officers for the upcoming year. The nominating committee proposed the election of a slate of officers including plaintiff Ketchum as chairman and plaintiff Bigler as president. An opposing slate was nominated, including neither plaintiff, but naming defendant

---

1 cont'd

Higham	(14,454 shares)
Hainsfurther	(6,500 shares)
Smith	(6,120 shares)
Parks	(3,850 shares)
Williams	(2,750 shares)
Sneath	(777 shares)
Corigliano	(389 shares)
Zimmerman	(5 shares)

At the time of the annual meeting, plaintiffs held 44% of the outstanding stock; six of the seven individual defendants held 48.6%. Pursuant to notice mailed April 5, 1976, shareholders representing some 440,000 shares of common stock were physically present at the shareholders meeting of April 23. Additional proxies representing 6,509 shares (naming plaintiffs as proxy) and 14,454 shares (naming Whitridge as proxy) were filed with the secretary prior to the meeting.

As of April 23, 1976, the following individuals were members of Babb's board of directors: plaintiff Ketchum; plaintiff Bigler, defendant Waugh; defendant Livingston; defendant Steele; defendant Green; defendant McCutchen; defendant Roof; defendant Hiltz; Whitridge; Hainsfurther.

Waugh as chairman and defendant Livingston as president. In the ensuing ballot, Ketchum and Bigler were defeated by a vote of 7 to 4 (the seven defendants against the two plaintiffs and the two additional directors). Waugh was elected chairman and Livingston was elected president.

Following the election of officers, a resolution to terminate Babb's employment of plaintiffs Ketchum and Bigler — neither of whom had employment contracts with the company or its subsidiaries -- was adopted by a similar 7 to 4 vote. Plaintiffs were discharged immediately, with one week's salary.

Upon termination of their employment, plaintiffs were required by the terms of previously-executed stock retirement agreements to resell their shares of Babb stock to the company.[2] All shares of Babb stock are held by employees pursuant to such

[2] Subsequent to Babb's incorporation, shares of its stock were made subject to a stock retirement or repurchase agreement. This was replaced by a similar agreement of November 18, 1968, which in turn was amended in 1969, 1971 and 1974.

stock retirement agreements, and all such agreements provide for the compulsory sale to and repurchase by Babb of all outstanding shares held by a shareholder "on his termination of employment for any reason or on his death." Babb has consistently enforced this stock retirement agreement — the provisions of which apparently were drafted at the instruction, and with the participation, of plaintiffs Ketchum and Bigler — against every employee terminated by the corporation. Accordingly, at the conclusion of the April 23 organization meeting, pursuant to the terms of the repurchase agreements executed by plaintiffs, Babb tendered checks and notes to Ketchum and Bigler in the contractually-obligated aggregate amount of $544,410, or $2.63 per share for 207,000 shares of company stock.[3]

[3] Under ¶5 of the stock retirement agreement, a shareholder whose employment is terminated for any reason other than death or normal retirement must sell all his stock, and the corporation must purchase it, at either $2.63 per share or the price the employee paid for the stock, whichever is greater. Plaintiffs each paid $.10 per share for their stock in Babb. As of December 21, 1975, the book value of such stock was approximately $1.46 per share.

Plaintiffs returned the checks and notes to defendants and subsequently filed the instant action, alleging, inter alia, federal securities fraud. They request, inter alia, that the Court enjoin defendants Waugh and Livingston from occupying the offices to which they were elected on April 23, return plaintiffs to their former positions and restrain defendants (a majority of the board of directors) "from taking any other action to change or disturb the arrangements for the management and operation of defendant Babb, Inc. . . ."

We emphasize at the outset that what has been set forth above is no more than a factual skeleton constructed for dispositional purposes, and does not purport to be a complete summary of the facts which give rise to the instant litigation. The circumstances surrounding the termination of plaintiffs' employment are both intricate and complex, and, in another forum, might well merit closer scrutiny. But such scrutiny is not automatically warranted here, where entitlement to any remedy is, initially, entirely dependent upon the Court's acceptance of the proposition that plaintiffs have alleged a cause of action under the federal securities law embodied in Rule 10b-5. If that proposition is rejected, our inquiry

is properly at an end, for, regardless of the legality vel non of defendants' conduct in ousting and discharging plaintiffs under state corporation law, this Court would lack jurisdiction to determine plaintiffs' pendent state claims. After a full hearing in this matter, and careful consideration of the various briefs and memoranda of the parties, I am persuaded that plaintiffs have failed to state a cognizable federal claim, and that the Court is therefore deprived of subject matter jurisdiction in this case.

The essence of Rule 10b-5 is its proscription of "fraud in connection with the purchase or sale of any security."[4] Plaintiffs endeavor to bring their action within the bounds of the Rule's proscription via the

---

[4] The Securities Exchange Act of 1934, as amended, provides in Section 10 (15 U.S.C. Sec. 78j) that:

> "It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails . . .
>
> "(b) To use or employ, in connection with the purchase or sale of any security . . . any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe. . . ."

allegation that, prior to April 23, 1976, defendants failed to disclose and tacitly misrepresented to fellow shareholders their intention to vote against the reelection of plaintiffs as officers and to terminate their employment with Babb at the organization meeting following defendants' own reelection to the board by the shareholders. Plaintiffs contend that this "active nondisclosure" amounted to fraud which directly infected the shareholder vote for directors,

---

4 cont'd

Rule 10b-5 (17 C.F.R. Sec. 240.10b-5) defines the practices forbidden as follows:

"It shall be unlawful . . .

(a) To employ any device, scheme, or artiface to defraud,

(b) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(c) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,

in connection with the purchase or sale of any security."

which in turn tainted the subsequent board votes to depose and discharge plaintiffs, which in turn triggered the operation of the stock retirement agreements compelling the sale and corporate repurchase of plaintiffs' Babb stock. Ergo, plaintiffs submit, a claim for fraud "in connection with the purchase or sale" of a security has been stated in this case.

The Court does not agree. It is not necessary to engage in lengthy discourse on each of the requisite elements of a cause of action under Rule 10b-5, [5] or to address each of the parties' multiple and rather sophisticated arguments regarding the existance vel non of such elements in these circumstances. It is sufficient to note that the "in connection with" language of Rule 10b-5 requires a showing of causation between the alleged fraud and a plaintiff's sale (or purchase) of a security, see Affiliated Ute Citizens v U. S., 406 U.S. 128, 154 (1972), and to

---

5 In this regard, see Thomas v. Duralite Co., 524 F.2d 577 (3d Cir. 1975); Fenstermacher v. Philadelphia National Bank, 493 F.2d 333 (3d Cir. 1974); Rochez Bros. v. Rhoades, 491 F.2d 402 (3d Cir. 1974).

express the Court's basic view that the instant plaintiffs cannot be deemed to have satisfied this causation requirement where the sale of their Babb stock occurred solely as a matter of contractual obligation, by operation of long-standing stockholders retirement agreements between plaintiffs and the company, and not as the result of the allegedly tainted stockholders' vote for directors. Indeed, it is difficult to discern any merit in the contention that defendants' assertedly fraudulent conduct caused the instant securities transaction when it is clear that it was plaintiffs' termination, and not their ouster as officers, that triggered the forced sale and repurchase of their stock. Inasmuch as defendants constituted a majority of Babb's board of directors prior to the 1976 shareholders meeting and therefore could have caused Babb to terminate plaintiffs at any time prior thereto, the sale of plaintiffs' stock was not caused by any fraud that might have affected the results of the annual meeting. Accordingly, the Court would be compelled to find an absence of causation in this case even if it were to accept the rather dubious propositions that the alleged non-

disclosures amounted to actionable fraud[6] and that such fraud caused plaintiffs' ouster as officers of the company.

The above result necessarily follows from an orthodox causation analysis. The causation element of Rule 10b-5 may be evaluated through the application of materiality and reliance tests. See Harnett v. Ryan Homes, Inc., 496 F.2d 832 (3d Cir. 1974). The

---

6 For purposes of the above discussion, the Court assumes the existence of actionable fraud. That assumption, however, is made arguendo only — indeed, the Court would have serious problems with a finding of actionable fraud on these facts. Given my view on the causation issue, these problems need not be fully developed here. However, the Court's doubts regarding actionable fraud in this instance are deep enough to have had some supportive impact on its decision, and it is therefore necessary to note, without holding, that defendants appear to have acted in this matter entirely within the confines of Pennsylvania corporation law as well as Babb's by-laws and articles of incorporation. It is far from clear that, prior to April 23, 1976, defendants were under any legal duty to disclose their intentions to oust and terminate plaintiffs. See e.g. Phillips v. Reynolds & Co., 294 F.Supp. 1249, 1255 (E.D. Pa. 1969) (holding that a nondisclosure is not per se actionable fraud under Rule 10b-5 unless the defendant was under a duty to make a disclosure concerning the subject).

former is measured by the standard of "whether a reasonable man would attach importance [to the undisclosed or misrepresented facts] in determining his choice of action in the transaction in question." Rochez Bros. v. Rhoades, supra at 408 (citations omitted). The latter is judged by whether the plaintiff would have acted differently had he known the undisclosed or misrepresented information. Id. at 410-411. Obviously, neither objective materiality nor subjective reliance is present here. Plaintiffs were contractually bound to sell their shares to Babb upon termination of their employment. They had no choice in this matter at the time of the operative events in this case. Clearly, the alleged fraud could not have influenced a reasonable man's decision to sell his stock to Babb after termination when that man had previously committed himself to such a sale; nor could plaintiffs themselves have relied on allegedly fraudulent acts occurring long after plaintiffs had contracted to make the sale in question. Thus, as a matter of traditional analysis, as well as pursuant to a conviction that the relationship between the nondisclosures and the forced sale of plaintiffs' shares is simply too attenuated to present a viable Rule 10b-5 claim, the Court must conclude that the requisite causation is absent in this case.

It is important to recognize in this regard that there has been no allegation of fraud or deceit surrounding plaintiffs' signing of the original stockholders retirement agreements in 1962 or the various amendments thereto since that time. Moreover, the agreements in question clearly appear to be facially valid, and, as a species of contract, are in no way inherently suspect: similar provisions have been upheld by the courts, see, e.g., Clayton v. Clow & Sons, 327 F.2d 382 (7th Cir. 1964), and would appear to be authorized by statute in this Commonwealth (15 Pa. Stat. Annot. §1613.1C). In sum, the record is utterly devoid of anything to indicate that the stock retirement agreements between plaintiffs and Babb are themselves tainted by fraud or invalid in any respect.[7]

---

[7] The Court has not failed to consider plaintiffs' assertion that under the terms of the instant agreements, they will receive an inadequate consideration for their shares of Babb stock, and that the forced sale of such stock "at a fraction of its fair market value" operates to enhance the value of defendants' shares. This, plaintiffs submit, raises a compelling inference that they are being "squeezed out" of ownership in the corporation for defendants' personal pecuniary benefit. Citing two Second Circuit decisions (Green v. Santa Fe Industries, Inc., CCH Fed. Sec. L.Rep. ¶ 95,447 (1976) and Marshel v. AFW Fabric Corp., CCH Fed. Sec. L.Rep. ¶ 95,448 (1976)), plaintiffs contend that such a squeeze-out of a minority by and for the personal benefit of those in control of a corporation constitutes actionable fraud under Rule 10b-5.

In these circumstances, only the most boundlessly expansive reading of Rule 10b-5 would permit the Court to discern the existence of a cause of action for federal securities fraud. In this vein, I am mindful of the Supreme Court's admonition that Rule 10b-5 must be read "flexibly." Superintendent of Insurance v. Bankers Life & Casualty Co., 404 U.S. 6, 12 (1971). But the very word implies contraction and

7 cont'd

We note initially that the cases cited by plaintiffs are clearly distinguishable from the suit sub judice. See Marsh v. Armada Corp., CCH Fed. Sec. L. Rep. ¶ 95,496 at 99,525 (6th Cir. 1976) (stating that Green and Marshel "cannot be read apart from the milieu of 'going private' merger transactions"). Moreover, even if applicable herein, these decisions apparently require a showing that (1) defendants have acted without any justifiable business purpose and (2) that plaintiffs are receiving a wholly inadequate consideration for their shares of stock. Nash v. Farmers New World Life, CCH Fed. Sec. L.Rep. ¶ 95,519 at 99,661 (S.D. Ohio 1976). The Court intimates no view with regard to the existence vel non of a justifiable business purpose for defendants' actions in this matter. As to the second requirement, however, it is in these circumstances quite simply impossible to conclude that the consideration to be paid for plaintiffs' shares is wholly inadequate. Per their contracts with Babb, plaintiffs are receiving $2.63

expansion in light of the circumstances, and clearly does not impart an unlimited scope to the Rule. Id. at 12. Moreover, in evaluating plaintiffs' apparent contention that 10b-5 reaches every securities transaction remotely related in any way to activities alleged to be fraudulent, it is important to consider that the broad exercise of federal jurisdiction, though sometimes clearly necessary or appropriate, amounts to nothing less than the broad assertion of federal power and, as such, never reverberates in a vacuum or impacts merely on an isolated lawsuit. Rather, each such exercise of jurisdiction works a diminution — both in an immediate, specific sense and as a

7 cont'd

per share for stock which they purchased at $.10 per share, or $540,000 for stock purchased for $20,700 in 1962. The evidence adduced at trial — including testimony that the book value of Babb's stock was $1.44 per share as of the first quarter of 1976, that plaintiffs previously made offers to defendant Livingston at $2.63 per share and that there exists a long history of corporate repurchases at the contract price — clearly indicates that the $2.63 per share price which Babb was obligated to offer plaintiffs is the fair value of their stock. Moreover, plaintiffs' $15 per share estimate is a valuation based on gross revenues, rather than on book values, earnings or agreed price. See Garrity, Buy-Sell Agreements, 46 Pa. B.Q. 190, 193 (March 1975). Plaintiffs plainly agreed (in ¶ 5) to the method of valuation in their

matter of precedent — of the state's power to determine controversies arising under its laws, and, in my view, such undertakings should therefore be confined to cases that pose questions of true federal significance. I do not believe that this is such a case.

In Blackett v. Clinton E. Frank, Inc., 379 F.Supp. 941 (N. D. Ill. 1974), the court dismissed a Rule 10b-5 claim on facts strikingly similar to those which obtain herein, stating as follows:

---

7 cont'd

stock retirement agreements. Not only do they appear to have been instrumental in devising such agreements, they also have in the past caused Babb to exercise similar agreements when other employee-shareholders were terminated. In such circumstances, plaintiffs cannot now be permitted to protest the fairness of the stock retirement agreements or the adequacy of the method of valuation which they embraced. See generally, Brown Estate, 446 Pa. 401 (1972); Mather Estate, 410 Pa. 361 (1963).

> "This is an example of a trend of cases in which the invocation of federal securities laws is wholly inappropriate and wide of the Congressional mark. . . . The vice of the instant complaint is that the plaintiff has engrafted upon a state cause of action a misplaced federal securities law claim which, but for that inappropriate federal gloss, would have been litigated in a local state court." Id. at 944 (citations omitted).

In my view, that language is entirely apposite in the context of the instant case. By any realistic standard of appraisal, plaintiffs' complaint goes to the propriety of their ouster and discharge, and not to the sale or purchase of their Babb stock. They have engrafted a remote wisp of a Rule 10b-5 claim upon a cause of action controlled entirely by state law governing the actions of the board of directors of a Pennsylvania corporation. The "federal gloss" on their lawsuit is simply too thin to invoke the Court's jurisdiction in this matter. Accordingly, the instant action will be dismissed by appropriate Order.

ORDER

AND NOW, to-wit, this 14th day of July, 1976, in consideration of the foregoing opinion in the above-captioned case, IT IS ORDERED that the complaint filed by plaintiffs at the above civil action number be and the same is hereby dismissed.

Upon consideration of plaintiffs' motion to reopen and for leave to engage in additional discovery, it appearing to the Court that defendant Roof's resignation from Babb, Inc. occurred after trial of this case and could have no bearing on any of the issues before the Court, and, further, that nothing in defendant Roof's letter of resignation indicates that the pretrial issuance to him of 7,500 shares of Babb, Inc. stock occurred in violation of the federal securities laws, IT IS FURTHER ORDERED that said

motion to reopen be and the same is hereby denied.

s/ Hubert I. Teitelbaum
Hubert I. Teitelbaum
United States District Judge

Copies to:

Edmund K. Trent, Esquire
Reed, Smith, Shaw & McClay
747 Union Trust Building
Pittsburgh, PA 15230

John J. McLean, Esquire
Buchanan, Ingersoll, Rodewald,
Kyle & Buerger
57th Floor, 600 Grant Street
Pittsburgh, PA 15219

IN THE UNITED STATES DISTRICT COURT
FOR THE WESTERN DISTRICT OF PENNSYLVANIA

CHANDLER G. KETCHUM and HAROLD S. BIGLER, Plaintifs,	)	
Plaintiffs,	)	Civil Action
v.	)	No. 76-571
EDWARD J. GREEN, HARRY B. HILTZ, JOHN C. McCUTCHEN, DAVID G. ROOF, WILLIAM M. WAUGH, JR., RONALD B. LIVINGSTON, WILLIAM M. STEEL, and BABB, INC.,	)	
Defendants.	)	

ORDER

AND NOW, to-wit, this 4th day of August, 1976, upon consideration of plaintiffs' motion to amend findings and conclusions set forth in the Court's Opinion of July 14, 1976 in the above-captioned case, IT IS ORDERED that said motion be and the same is hereby granted insofar as it relates to the Court's comment in footnote 7, page 10 that "the $2.63 per share price which Babb was obligated to

offer plaintiffs is the fair value of their stock." This finding is hereby amended to read that "the $2.63 per share price which Babb was obligated to offer plaintiffs does not constitute a wholly inadequate consideration for their stock." IT IS FURTHER ORDERED that insofar as it requests any further amendment of the Court's findings and conclusions in the above-captioned matter, plaintiffs' motion be and the same is hereby denied.

s/Hubert I. Teitelbaum
Hubert I. Teitelbaum
United States District Judge

copies to:

Edmund K. Trent, Esquire
Reed Smith Shaw & McClay
747 Union Trust Building
Pittsburgh, PA 15230

John J. McLean, Esquire
Buchanan, Ingersoll, Rodewald,
Kyle & Buerger
57th Floor, 600 Grant Street
Pittsburgh, PA 15219

UNITED STATES COURT OF APPEALS
FOR THE THIRD CIRCUIT

No. 76-2268

CHANDLER G. KETCHUM and HAROLD S. BIGLER,
Appellants

v.

EDWARD J. GREEN, HARRY B. HILTZ, JR., JOHN C. McCUTCHEN, DAVID G. ROOF, WILLIAM M. WAUGH, JR., RONALD B. LIVINGSTON, WILLIAM M. STEELE and BABB, INC.,

---

ON APPEAL FROM THE UNITED STATES DISTRICT COURT
FOR THE WESTERN DISTRICT OF PENNSYLVANIA
Civil No. 76-571

Argued May 3, 1977

Before: ALDISERT and ADAMS, *Circuit Judges,* and MARKEY, *Chief Judge,* United States Court of Customs and Patent Appeals*

EDMUND K. TRENT, ESQ.
CHARLES C. COHEN, ESQ.
JONATHAN W. DELANO, ESQ.
Reed Smith Shaw & McClay
Pittsburgh, Pa. 15219

Attorneys for Appellants

JOHN J. McLEAN, JR., ESQ.
THOMAS M. THOMPSON, ESQ.
LEWIS U. DAVIS, JR., ESQ.
Buchanan, Ingersoll, Rodewald, Kyle & Buerger
Pittsburgh, Pa. 15219

Attorneys for Appellees

---

*Sitting by designation.

OPINION OF THE COURT

(Filed June 30, 1977)

ADAMS, *Circuit Judge.*

The issue in this appeal is whether the district court erred when it dismissed the complaint in a dispute arising out of an intra-corporate contest for control of a close corporation. Specifically, we must ascertain whether the factual matrix here satisfies the "in connection with" clause of § 10(b) of the Securities Exchange Act of 1934 and its administrative derivative, Rule 10b-5—a clause which requires for a cause of action that a misrepresentation be rendered *in connection with* a sale or purchase of a security.

I.

Although the background for the litigation is somewhat complex, for purposes of this appeal we need only outline those facts pertinent to our decision.

Plaintiffs Ketchum and Bigler are the former Chairman of the Board and President, respectively, of Babb, Inc., a close corporation engaged in the insurance business. In addition to serving as directors of the company, both men were holders of substantial portions of the outstanding Babb stock, owning between them roughly forty-five per cent of such shares. The seven individual defendants constituted other directors and officers of Babb, with five of them holding approximately forty-eight per cent of the outstanding stock.

Under terms contained in a stock retirement agreement, dated November 18, 1968, all Babb shareholders are required to be employees of the corporation. Upon death, retirement or disability, a shareholder or his representative must surrender his stock, and the company is required to redeem such securities at a price determined by a formula relating to corporate income. In the event of a

termination of employment for any other reason, only one-third of such formula price would be paid.[1]

Late in 1975, several of the defendants began discussions among themselves as to the possibility of removing Ketchum and Bigler as officers and employees of Babb. During the ensuing months, the same coterie of defendants continued to discuss the ouster of Ketchum and Bigler, enlisted the support of the remaining defendants, but concealed their scheme from the plaintiffs.[2]

In March of 1976, the entire board of directors, including the plaintiffs as well as the defendants, proceeded to appoint a committee to select nominees for the board and officer elections that were scheduled for the month of April. The committee, consisting of one of the plaintiffs, one of the defendants and another director of the company, decided to nominate the incumbent board members and officers, among them the two plaintiffs.

On April 23, 1976, the nominating committee submitted its slate of candidates for the board and officerships. The list was received, without any signs of dissension, at a directors' meeting that preceded the annual meeting of shareholders. By this juncture, the defendants had agreed among themselves to dislodge the plaintiffs as officers. Nevertheless, the defendants did not reveal their intention to oppose the reelection of the plaintiffs as officers, making no disclosure of their plan to depart from the usual practice of supporting candidates selected by the nominating committee.

---

1. At the time of this lawsuit, the prevailing repurchase price on death, retirement or disability was $7.90 per share. The corresponding price to be paid upon other forms of employment termination was $2.63. Plaintiffs claim, however, that their stock was worth $15.00 per share during the period covered by this action.

2. In their briefs, the plaintiffs also allege that 7,500 shares were secretly and unlawfully issued to defendant David Roof by the other defendants in an attempt to gain a majority of the outstanding shares. Whether such issuance was unlawful is questionable, since the parties' stipulation of facts (see Appendix at 27a) reproduces the minutes of a meeting of the Babb board of directors, held March 8, 1977, which "reaffirmed that Mr. Roof [held] an option for 7,500 shares. . . ." Even including the stock attributable to defendant Roof, the defendants still evidently lacked a majority position among the shareholders. *See* footnote 1 of the opinion of the district court, reported at 415 F. Supp. 1367 (W.D. Pa. 1976).

During the April 23 shareholders' meeting, the defendants continued to conceal their plans regarding the election of officers. There is some indication that they did so out of necessity. Although the defendants constituted a majority of the board of directors, they held slightly less than fifty per cent of the outstanding Babb stock. Indeed, at the time of the shareholders' meeting, it was Ketchum and Bigler who possessed the controlling bloc of stock, given their own holdings together with proxies that they had obtained. Nevertheless, the plaintiffs, assuming that the defendants would support all of the candidates designated by the nominating committee, and having no reason to believe otherwise, joined with the defendants and other shareholders to reelect unanimously the incumbent directors. The result of the election was to return the defendants to their dominant position on the directorate.

Immediately following the meeting of the shareholders, the board of directors convened to elect company officers. The slate formulated by the nominating committee then was proposed. At that moment, the defendants made known, for the first time, their intention to expel Ketchum and Bigler as corporate officers. Rejecting the nominations of the plaintiffs, the defendants instead produced their own candidates for the positions of chairman of the board and president. The nominees of the defendants then were elected, thereby removing Ketchum and Bigler as officers.

Once the purge of the plaintiffs as officers was accomplished, the defendants, comprising a majority of the board, proceeded summarily to terminate Bigler and Ketchum as Babb employees as well. Thereafter, the board adopted a resolution to purchase plaintiffs' shares, as authorized by the stock retirement plan, and then tendered payment for the purchase price. But Ketchum and Bigler have declined to surrender their stock certificates or accept any payment for such shares.

Subsequent to these events, plaintiffs initiated the present lawsuit, seeking, *inter alia*, to enjoin their ouster as officers and shareholders of Babb and to secure damages. Basically, Bigler and Ketchum claim that the defendants, in violation of § 10(b) and Rule 10b-5, had fraudulently induced them to vote for their own demise. By masking and supposedly misrepresenting their intentions with respect to the officership election, the defendants, it is asserted, were able to retain their majority bloc on the board of directors, despite their minority position among the company stockholders. According to Ketchum and Bigler, such alleged improprieties in turn tainted the subsequent vote by the directors to depose and discharge the plaintiffs as officers, which then facilitated the removal of plaintiffs as employees, and which ultimately activated the stock retirement agreement compelling the sale and corporate repurchase of plaintiffs' stock.

After the entry of a stipulation of facts and a hearing concerning the plaintiffs' demand for injunctive relief, the district court dismissed the action for failure to state a claim under § 10(b) and Rule 10b-5. This appeal followed.

II.

By now, § 10(b) of the 1934 Act[3] and Rule 10b-5,[4] promulgated thereunder, are together recognized as a

3. Section 10(b), 15 U.S.C. § 78j, provides in pertinent part:

"It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails . . .

(b) To use or employ in connection with the purchase or sale of any security . . . any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe. . . ."

4. Rule 10b-5, 17 C.F.R. § 240.10b-5, declares:

"It shall be unlawful . . .

(a) To employ any device, scheme, or artifice to defraud,

(b) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(c) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person in connection with the purchase or sale of any security."

For purposes of this opinion, references to § 10(b) should be viewed as encompassig Rule 10b-5, the administrative derivative of the statute.

cornerstone of the federal program of securities regulation. The statute has been applied to a plethora of activities involving securities, including insider trading based on undisclosed corporate information, misleading corporate publicity and banker-dealer conduct. This lawsuit, however, concerns the application of § 10(b) to another category of activity—an internal struggle for control of a close corporation.

To set forth a claim under § 10(b), the complaint, before trial, and the record, following the completion of evidentiary processes, must enunciate the factual underpinnings for an exercise of authority by the federal courts. Although the provision articulates a number of prerequisites, the existence of three key elements is necessary if a cause of action is to obtain. First, there must be misrepresentation or fraud; second, a purchase or sale of a security must occur; and third, such misrepresentation or fraud must have been rendered *"in connection with"* the purchase or sale of a security.

Battle has been waged, of course, on many occasions over whether there has been compliance with the "fraud"[5] or "purchase/sale"[6] requirements of § 10(b). By contrast, the "connection" factor has received relatively scant consideration by the Supreme Court and other federal tribunals. Yet this litigation, in large measure, turns on the "connection" facet of § 10(b).

In its opinion, the district court decided that there was no basis for recovery under § 10(b). It did so on the ground that the claimed misrepresentation of the defendants did not occur *"in connection with"* a purchase or sale

5. *See, e.g.*, Santa Fe Industries, Inc. v. Green, — U.S. —, 45 U.S.L.W. 4317 (March 23, 1977), Affiliated Ute Citizens of Utah v. United States, 406 U.S. 128, 150-154 (1972); SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 848-53, 862-863 (2d Cir. 1968), *cert. denied sub nom.* Coates v. SEC, 394 U.S. 976 (1969).

6. *See, e.g.*, SEC v. National Securities, Inc., 393 U.S. 453, 464-468 (1969); *In re* Penn Central Litigation, M.D.L. Docket No. 56, 494 F.2d 528, 532-539 (3d Cir. 1974); Hooper v. Mountain States Securities Corp., 282 F.2d 195, 200-03 (5th Cir. 1960), *cert. denied*, 365 U.S. 814 (1961).

of securities. For purposes of such a disposition of the case, the trial judge assumed that the defendants had engaged in actionable fraud or deception, although his opinion voices grave "doubts" whether the conduct of the defendants constituted misrepresentations within the meaning of § 10(b).[7]

We now affirm the conclusion of the district judge that the relationship between the alleged misrepresentations and the sale/purchase with respect to plaintiffs' shares does not satisfy the "in connection with" requirement of the statute. Our position, however, diverges to some extent from that of the trial court, thereby making appropriate a full consideration of the "connection" question. In our analysis, we, too, shall assume that the defendants have engaged in a deceptive practice within the meaning of § 10(b).

III.

A.

It is not surprising that the "in connection with" clause of § 10(b) has received limited attention from the federal courts. In the usual case, where the alleged deception concerns the terms of a securities transaction, there can be little question that the "connection" requirement has been fulfilled. It is in the less typical situation, such as the one before us, that the "in connection with" language may prove more troublesome.

The leading Supreme Court case dealing with the "connection" proviso of § 10(b), and the one upon which the plaintiffs primarily rely, is *Superintendent of Life Insurance v. Bankers Life and Casualty Co.*[8] In that case, a private action under Rule 10b-5, the trustee in bankruptcy of the Manhattan Life Insurance Company alleged that the defendants had conspired to misappropriate corporate assets through various securities transactions.

7. 415 F. Supp. at 1371 n.6.

8. 404 U.S. 6 (1971).

One of the defendants in *Bankers Life* had agreed to purchase all of Manhattan's stock for $5 million and, conspiring with several companions, drew a check for the purchase price on a New York bank. After replacing Manhattan's board of directors with new members, the defendants prevailed upon such board to sell U.S. Treasury bonds held by the company for roughly $5 million. This sum was then deposited by the defendants with the bank to cover the original check for the stock purchase. A series of intricate maneuvers followed in an attempt by the defendants to conceal the misappropriation and to deceive the board of directors as to the purpose of the bond transaction.

Dismissing the complaint in *Bankers Life,* the district court held that the transaction concerning the sale of the Treasury bonds was not connected with the fraud.[9] And the Second Circuit affirmed this dismissal.[10] Basically, these courts reasoned that the subterfuge involved merely the theft of bond proceeds after their receipt by the corporation and that the securities transaction itself remained unaffected by the fraud. But the Supreme Court reversed.

In his opinion, Justice Douglas ruled that the misappropriation of the bond proceeds was sufficiently connected with a securities transaction so as to bring the theft within the reach of § 10(b). In so holding, the *Bankers Life* Court declared that, in order to invoke the protection of § 10(b) and its derivative rule, a party must be defrauded "as a result of deceptive practices touching its sale [or purchase] of securities . . . ."[11] The Court also instructed that § 10(b) "must be read flexibly, not technically and restrictively."[12] Consequently, the complaint was reinstated, and the case remanded for trial.

9. 300 F. Supp. 1083 (S.D.N.Y. 1969).

10. 430 F.2d 355 (2d Cir. 1970).

11. 404 U.S. at 12-13.

12. *Id.* at 12.

Subsequent to *Bankers Life,* federal tribunals have tended to construe the "in connection with" element of 10(b) broadly.[13] Such courts have focused on the language in the *Bankers Life* opinion which suggests that the protection of the statute is available when there are "deceptive practices *touching* [the] sale [or purchase] of securities. . . ." Almost without exception, they have found compliance with the "connection" requirement even where fraudulent conduct is implicated only tangentially in a securities transaction. Yet these courts have not attempted to etch more finely the contours of the "in connection with" clause. And so *Bankers Life* remains as the precedent with which we must concern ourselves.

Even though the federal courts, by and large, have not felt compelled to engage in a searching exegesis respecting the "connection" facet of § 10(b), a few judges have recognized that the teachings of *Bankers Life* are hardly refined or capable of facile application. In *Smallwood v. Pearl Brewing Company,*[14] for example, Judge Wisdom declared: "We do not hazard an opinion as to the outer limits of [the *Bankers Life*] test. It is important that the standard be fleshed out by a cautious case-by-case approach."[15] Such an approach is, in our view, the proper one for the current inquiry. This is especially so since we are called upon to delineate the perimeters of § 10(b) by determining whether the "connection" element has been satisfied in the litigation before us.

Ketchum and Bigler argue that the misrepresentations alleged by them do "touch" a securities transaction. They maintain that it was the failure of the defendants to disclose the plan to remove them from office which set in operation a chain of events that ultimately culminated in the forced sale of plaintiffs' shares. To so interpret *Bank-*

13. *See, e.g.* Jannes v. Microwave Communications, Inc., 461 F.2d 525, 529 (7th Cir. 1972); Drachman v. Harvey, 453 F.2d 722, 736-38 (2nd Cir. 1972) (en banc).

14. 489 F.2d 579 (5th Cir. 1974).

15. *Id.* at 595.

ers Life is not entirely devoid of merit. Commentators have suggested that the "touch" language of the *Bankers Life* opinion could be interpreted to cover practically all disputes relating to intra-corporate management.[16]

We do not believe, however, that *Bankers Life* was intended to be so encompassing in its embrace. Justice Douglas emphasized, quite explicitly, that not all intra-corporate controversies fall within the scope of § 10(b). Indeed, his opinion states that "Congress by § 10(b) did not seek to regulate transactions which constitute no more than internal corporate mismanagement."[17] If the present action essentially involves an instance of internal corporate mismanagement, then it would appear that the "touch" test of *Bankers Life* would not draw this lawsuit within the coverage of § 10(b).

Upon review of the stipulation of facts and the record of the proceedings before the district court, it becomes clear that the case at hand involves little more than allegations pertaining to an internal corporate conflict. Although the complaint seemingly stresses the importance of the relinquishment of plaintiffs' shares under the stock retirement plan, the factual stipulation and other segments of the record are largely silent on this point. For example, it is only in the concluding paragraphs of the stipulation that there is any mention of the forced sale of securities.[18] It thus is manifest that the essence of the plaintiffs' claim concerns their dismissal as officers of Babb, Inc.

Even the complaint itself belies the characterization of this case as more than an affray pertaining to internal corporate relationships. For a substantial portion of the relief sought is directed against the termination of the plaintiffs as officers of the company. Not only do Ketchum

16. *E.g.*, Note, *The Controlling Influence Standard in Rule 10b-5 Corporate Mismanagement Suits*, 86 Harv. L. Rev. 1007, 1013-14 (1973); *The Supreme Court: 1971 Term*, 86 Harv. L. Rev. 50, 263-264 (1972).

17. 404 U.S. at 12.

18. The stipulation of facts devised by the parties is set forth in the Appendix at 14a-33a. For a copy of the complaint, see Appendix at 5a-11a.

and Bigler desire to enjoin the defendants from assuming their former positions, but they also seek to render nugatory the fateful shareholders' and directors' meetings of April 23. While it is true that the plaintiffs also seek to enjoin the operation of the stock retirement program, this factor does not modify the elemental nature of the controversy—namely, a dispute arising from an internal contest for control of a corporation.

It would appear, then, that the present case does not constitute an instance in which misrepresentations were tendered "in connection with" a securities transaction. To the contrary, the purportedly deceptive practices occurred, if at all, in connection with the struggle for control of the corporation. Unlike *Bankers Life*, where the fraudulent conduct of the defendants undergirded the securities transaction, it cannot be said here that the misrepresentations bear a similar relationship to the forced sale of plaintiffs' stock. Consequently, the conflict before us would seem to fall within the reach of the "internal corporate mismanagement" exception in *Bankers Life*.

B.

A second—and obviously related—basis for ruling that the current lawsuit does not fulfill the "connection" element of § 10(b) concerns the degree of proximity between the securities transaction and the claimed fraud. The Supreme Court's opinion in *Bankers Life* does not reveal how close a nexus must exist between a misrepresentation and a transaction.[19] Nonetheless, it is quite evident that there was a fairly tight linkage between these elements in the *Bankers Life* setting: the theft of the consideration flowing from the sale of the bonds was only one step re-

19. Speaking on the "proximity" facet of the "in connection with" clause, one commentator has posited: "Application of the [*Bankers Life*] test on an *ad hoc* basis . . . [is] necessary to determine whether, in a given case, the relationship between the fraud and the securities transaction is too attenuated to support a 10b-5 claim." Jacobs, *The Role of the Securities Exchange Act Rule 10b-5 in the Regulation of Corporate Management*, 59 Cornell L. Rev. 27, 43 (1973).

moved from the bond transaction itself. Put another way, the bond transaction in *Bankers Life* was clearly undertaken for the purpose of making possible the practices alleged to be deceptive—in particular, the misappropriation of the proceeds and their application so as to achieve a costless acquisition of the Manhattan stock.

By contrast, the degree of proximity seems to be far more attentuated in the situation before us. Instead of being merely one step away from a securities deal, the supposed deception here is somewhat removed from the ultimate transaction. Indeed, there are a substantial number of intermediate steps between the fraud and the accomplishment of the forced sale of plaintiffs' shares: the shareholders' vote subsequent to the misrepresentation; the ensuing meeting of the company directorate during which the plaintiffs were removed as officers; and the adoption of the resolution terminating the plaintiffs' status as company employees. Only the last development triggered the operation of the stock retirement program, compelling Ketchum and Bigler to tender their shares to the corporation.

It thus is evident that the alleged misrepresentations on the part of the defendants were undertaken with the objective of inducing the expulsion of the plaintiffs as officers and employees—not to foster the surrender of their stock. While it may be that the surrender of the shares will constitute a *consequence* of the defendants' overall scheme, we believe that such a consequence, at best, will be an indirect one. Accordingly, it would appear that the deceptive practices in which the defendants are alleged to have engaged and the ultimate sale of plaintiffs' stock are not tied sufficiently tightly so as to surmount the "connection" requirement of § 10(b), even as broadly formulated in *Bankers Life.*

C.

This Court has addressed itself to the "connection" issue on only a few occasions. Perhaps the most significant statement on the matter is contained in *Tully v. Mott Supermarkets, Inc.*[20] There, the "in connection with" clause was viewed as "contemplat[ing] a *causal connection* between the alleged fraud and the purchase or sale of stock."[21] And in *Tully,* which involved allegations of fraud relating to the purchase of treasury stock by a class of corporate stockholders, the Court deemed the "requisite causal connection [to be] lacking."

In the present litigation, the trial court, though not citing *Tully,* similarly perceived the "connection" problem in terms of causation. It stated, for example, that "the 'in connection with' language of Rule 10b-5 requires a showing of causation between the alleged fraud and a plaintiff's sale [or purchase] of a security. . . ."[22] With this causation principle in mind, the district judge decided that the plaintiffs had failed to satisfy the "in connection with" requirement. The reasoning underlying this determination was that the operation of the stock retirement agreement—*not* any deceptive practices on the part of the defendants—caused the securities transaction involved in this action.

While it may be that *Bankers Life* suggests that the "connection" element of § 10(b) is not precisely the same as causation, since the bond sale only *made possible* the accomplishment of the fraud as opposed to having *caused* it, the two concepts are similar to one another. This is so because both the "connection" and "causation" principles speak to the degree of proximity required between a misrepresentation and a securities transaction.

If we deem "connection" and "causation" to be closely intertwined, and we may be obliged to do so in light of the recent statements of this Court in *Tully,* then it would appear that the plaintiffs simply have failed to bring their

20. 540 F.2d 187 (3d Cir. 1976). *Accord:* Vincent v. Moench, 473 F.2d 430, 434 (10th Cir. 1973).

21. *Id.* at 194.

22. 415 F. Supp. at 1371.

case within the ambit of § 10(b). The stock retirement program, to which plaintiffs and all other Babb employees are signatories, stands as the direct cause of the forced sale of the stock in the present context. Assuming that the supposed misrepresentations of the defendants did set into motion a chain of events which culminated in the securities transaction, we believe that the retirement agreement operates as an independent and intervening cause of such transaction—a force that serves to disrupt the connection between the challenged conduct on the part of the defendants and the relinquishment of plaintiffs' shares.

D.

Dismissal of the complaint for failure to comport with the "in connection with" clause of § 10(b) would appear to be in order for another reason, one that is implicit in the foregoing discussion. To rule otherwise, and to reinstate the present lawsuit, might tend to promote further incursions by federal courts into areas and activities now regulated by state corporation laws. While the coverage of § 10(b) may well have been intended by Congress to overlap somewhat with that of certain state provisions, it is questionable whether the scope of the statute should be extended to all phases of corporate operations and relationships whenever they entail the incidental involvement of securities. Realistically, there are a multitude of corporate decisions and endeavors which implicate securities in some fashion.

It is apparent, in our view, that § 10(b) was not designed to preempt, in effect, a large number of state corporation provisions. Yet the plaintiffs' expansive reading of the "in connection with" clause might open the door to such a development. We are, however, unwilling to accede to the position advanced by Ketchum and Bigler, especially in the absence of a precedential or legislative mandate to do so. As noted above, the Supreme Court indicated in

Bankers Life that the statute should not be construed so as to foster the federalization of corporate law.[23] Not only is the legislative history of § 10(b) silent in this regard, but Congress repeatedly has rebuffed various proposals to preempt, in whole or part, the field of corporate regulation.[24] Carried to its natural terminus, the plaintiffs' construction of the "connection" proviso would serve to empty it of any real substantive content.

Conceivably, the plaintiffs may have some compensable claim against the defendants under the Pennsylvania corporation laws. Whether they do is a matter that may not be dealt with by this Court, at least in the present case, since there is no basis for an exercise of federal diversity or other jurisdiction. Any relief that may be available to the plaintiffs is a matter to be decided in a state forum.

E.

Because of the above considerations, we conclude that any fraudulent activity engaged in by the defendants cannot be said to have occurred "in connection with" the surrender of plaintiffs' stock to the company.

IV.

The defendants in this appeal proffer a second basis for ruling that the plaintiffs have failed to state a claim, maintaining that the ouster plan did not encompass fraudulent practices actionable under § 10(b). In view of our decision with respect to the "in connection with" require-

---

23. *See* text accompanying note 17 *supra*.

24. For a brief narration of several unsuccessful attempts to promulgate federal corporation laws, see 1 L. Loss, SECURITIES REGULATION 107-11 (2 ed. 1969) and Ruder, *Pitfalls in the Development of Federal Law of Corporations by Implication Through Rule 10b-5*, 59 NW. U.L. Rev. 185, 206-207 (1964).

ment of the statute, however, we need not address the question as to the existence of the requisite deception.[25]

The judgment of the district court, dismissing the complaint, will be affirmed.

---

25. At oral argument, it also was questioned whether a sale or purchase of securities had occurred. Since a sale or purchase is a prerequisite for § 10(b) jurisdiction, the absence of such a transaction would, in itself, necessitate a dismissal of the complaint.

In the instant context, the plaintiffs have refused to surrender their shares to the corporation, repeatedly rejecting the payments that have been tendered to them. Because the redemption has not yet been consummated, it might be contended that plaintiffs have been premature in bringing their action. Nonetheless, it would appear that there already has been compliance with the "purchase/sale" requirement of § 10(b). This is so since 15 U.S.C. § 78(c)(13) and (14) define "purchase" and "sale" to "include any contract to buy, purchase or otherwise acquire . . . [and] any contract to sell or otherwise dispose of." The stock retirement agreement here, despite the open-ended condition precedent that the plaintiffs be terminated as Babb employees, seemingly falls within the ambit of § 78(c), thereby satisfying the "purchase/sale" clause of § 10(b).

A True Copy:

Teste:

Clerk of the United States Court of Appeals for the Third Circuit.

(A.O.—U. S. Courts, International Printing Co., Phila., Pa.)

UNITED STATES COURT OF APPEALS

FOR THE THIRD CIRCUIT

No. 76-2268

CHANDLER G. KETCHUM and HAROLD S. BIGLER,
Appellants

vs.

EDWARD J. GREEN, HARRY B. HILTZ, JR., JOHN C. McCUTCHEN, DAVID G. ROOF, WILLIAM M. WAUGH, JR., RONALD B. LIVINGSTON, WILLIAM M. STEELE, and BABB, INC.,

(D.C. Civil No. 76-571)

ON APPEAL FROM THE UNITED STATES DISTRICT COURT FOR THE WESTERN DISTRICT OF PENNSYLVANIA

Present: ALDISERT and ADAMS, Circuit Judges and MARKEY, Chief Judge United States Court of Customs and Patent Appeals*

*Sitting by designation.

JUDGMENT

This cause came on to be heard on the record from the United States District Court for the Western District of Pennsylvania and was argued by counsel on May 3, 1977.

On consideration whereof, it is now here ordered and adjudged by this Court that the judgment of the said District Court, filed July 14, 1976, as amended August 4, 1976, be, and the same is hereby affirmed. Costs taxed against appellants.

ATTEST:

s/ Thomas F. Quinn
Clerk

June 30, 1977

SECURITIES EXCHANGE ACT OF 1934

SECTION 10

REGULATION OF THE USE OF MANIPULATIVE AND DECEPTIVE DEVICES

Sec. 10. It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—

(a) To effect a short sale, or to use or employ any stop-loss order in connection with the purchase or sale, of any security registered on a national securities exchange, in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

SECURITIES AND EXCHANGE COMMISSION

RULE 10b-5

10b-5 Employment of manipulative and deceptive devices.

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange.

(a) To employ any device, scheme, or artifice to defraud,

(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,

in connection with the purchase or sale of any security.